

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Fixed Income -
Securities Lending Policy

ITEM NUMBER: 5

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: May 5, 1999

INFORMATION:

PRESENTER(S): Ms. Cunningham
 Mr. Hosokawa

EXECUTIVE SUMMARY

The California State Teachers' Retirement System (CalSTRS) has developed a Securities Lending Program designed to enable CalSTRS to use its existing asset base and investment expertise to generate additional income. The income generated from any particular loan is dependent upon two factors: 1) the negotiated lending terms agreed upon at the outset of the loan and, 2) the return generated from the management of the cash taken as collateral for the loan. CalSTRS manages its Securities Lending Program within the following arrangements, in an attempt to provide an appropriate balance between risk control and diversification:

- Agent Lending/Agent Cash Collateral Management
- Agent Lending/CalSTRS Cash Collateral Management
- Principal Lending/CalSTRS Cash Collateral Management

Under the first arrangement, a portion of the Securities Lending Program is managed on an agent basis in which both the lending terms and the collateral management are the responsibility of an external contractor acting as a fiduciary for CalSTRS. Under the second arrangement, the external contractor negotiates the lending terms, while the cash collateral is managed internally within CalSTRS' Fixed Income Unit. Under the final arrangement, a portion of the program is managed on a principal basis, in which the responsibility for both the lending terms and the collateral management belong to CalSTRS Fixed Income staff.

One of the 1998/99 objectives approved for the Investment Branch is to review each of the policies to ensure completeness and consistency, with revisions to be made as necessary.

Attachment 1 represents the Securities Lending Program Policy Manual, which outlines the policies of CalSTRS' Securities Lending Program. This manual includes revisions to the previous Securities Lending Program Policy Manual that was updated in January 1998. Most of

the revisions represent changes in format and structure in order to be consistent with the other portfolios and programs managed within the Investment Branch.

These policies have been designed to set the boundaries for the structure and oversight of the management of the program, as well as to manage the risks associated with securities lending. Also included is a flow chart in order to provide the context for the policies within the general process of implementing the Securities Lending Program. The policies are intended to be static in nature and will be returned to the Investment Committee prior to changes being implemented.

RECOMMENDATION

Staff and Pension Consulting Alliance recommend that the Investment Committee approve the Securities Lending Program Policy Manual by adopting the attached resolution (Attachment 2).

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

SECURITIES LENDING PROGRAM POLICY MANUAL

INVESTMENT BRANCH
May, 1999

**California State Teachers’ Retirement System
Securities Lending Program Policy Manual**

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California State Teachers' Retirement System Securities Lending Program Policy Manual

INTRODUCTION

~~The California State Teachers' Retirement System (STRS) has designed an Off Balance Sheet Program, enabling STRS to use its existing asset base and liquidity strength to generate fee income. The management of this program is performed internally under the direction of the Chief Investment Officer, or his designee, as outlined in Diagram A. The following programs have been determined as meeting the established investment criteria of being prudent and risk averse:~~

- ~~Credit Enhancement/Liquidity Enhancement~~
- ~~Currency Hedging~~
- ~~Securities Lending~~

~~Securities Lending Program is designed to be an agreement where STRS transfers between a lender and a borrower to transfer ownership of a security for a predetermined time period temporarily in order to earn additional income. STRS retains the market price volatility and receives all interest and dividend payments. These loans can be overnight, open (terminable on demand), or for a specified period of time. The income earned from any particular loan is dependent upon two factors: 1) the negotiated lending terms agreed upon at the outset of the loan and, 2) the returns generated from the management of the cash collateral. The lender retains ownership rights of the security and is entitled to any distributions that occur with respect to that security during the life of the loan, such as coupon and dividend payments. The borrower backs the agreement by delivering collateral to the lender, either in the form of cash, which is currently the dominant form of collateral in securities lending transactions, or other liquid securities, in an amount that exceeds the market value of the securities borrowed. At the end of the loan or on a periodic basis, the lender is compensated.~~

The California State Teachers' Retirement System (CalSTRS, System) has developed a Securities Lending Program designed to enable CalSTRS to use its existing asset base and investment expertise to generate additional income. The income generated from any particular loan is dependent upon two factors: 1) the negotiated lending terms agreed upon at the outset of the loan and, 2) the return generated from the management of the cash taken as collateral for the loan. CalSTRS manages its Securities Lending Program within the following arrangements, in an attempt to provide an appropriate balance between risk control and diversification:

- Agent Lending/Agent Cash Collateral Management
- Agent Lending/CalSTRS Cash Collateral Management
- Principal Lending/CalSTRS Cash Collateral Management

Under the first arrangement, a portion of the Securities Lending Program is managed on an agent basis in which both the lending terms and the collateral management are the responsibility of an external contractor acting as a fiduciary for CalSTRS. Under the second arrangement, the external contractor negotiates the lending terms, while the cash collateral is managed internally within CalSTRS' Fixed Income Unit. Under the final arrangement, a portion of the program is managed

on a principal basis, in which the responsibility for both the lending terms and the collateral management belong to CalSTRS Fixed Income staff.

The policies and procedures are designed to set boundaries for the management and oversight, as well as risk parameters, for each program. Policies are static in nature and will be returned to the Investment Committee prior to changes being implemented. This document outlines the internally approved policies of CalSTRS' Securities Lending Program, which have been designed to set boundaries for the structure and oversight of the management of the program, as well as to manage the risks associated with securities lending. Procedures describe the process to be followed while implementing the policies. Given the nature of the Off Balance Sheet Programs, dynamic procedures are required in order to facilitate the adaptation to the changing risk parameters in the marketplace. A flow chart is included to provide context for the policies within the general process of implementing the Securities Lending Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

SECURITIES LENDING PROGRAM POLICIES

May 1999

The following represent the approved policies ~~used~~ to be utilized in the management of CalSTRS' Securities Lending Program. ~~They~~ These policies are designed to set boundaries for the structure and oversight of the management of the program, as well as to ~~mitigate~~ manage the risks associated with securities lending. Policies approved by the CalSTRS Board cannot be altered without explicit approval from the CalSTRS Board.

1. **LAWS AND STATUTES** - The Securities Lending Program is to be managed in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries in accordance with the California State Teachers' Retirement Law and other applicable statutes.
2. **PROGRAM OBJECTIVES** - There are no explicit goals with respect to the nominal amount of ~~off-balance sheet~~ income generated by the Securities Lending Program. The performance objective for the program is to achieve lending income commensurate with: 1) the market demand for the securities made available for lending and, 2) the return earned on the investment of the cash collateral within the guidelines set forth by CalSTRS.
3. **COUNTERPARTY RISK** - ~~The securities lending agreements provide that~~ Each loan is shall be collateralized by securities and/or cash delivered to CalSTRS' Custodian/Sub-Custodian bank prior to the release of CalSTRS' assets. To protect CalSTRS, the borrower must post collateral in the form of cash and/or other approved securities in an amount that exceeds the market value of the securities borrowed. The margin percentages shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.
4. **COLLATERALIZATION** - The collateral is shall be marked-to-market daily in order to maintain the negotiated margin level. Given the dynamic nature of the securities lending markets, any nontraditional (traditional being defined as cash and U.S. Treasury and U.S. Agency securities denominated in U.S. dollars) collateral must be reviewed and approved by the Director of Fixed Income.
5. **BORROWER CONCENTRATION** - [Previously Policy #6] ~~The securities lending agreements provide that the contractor shall formally review the credit of all potential borrowers, compile and maintain an approved borrower list, and re-evaluate borrowers on this list semi-annually.~~ Borrower diversification shall be reviewed in order to evaluate and control the borrower exposure within the Securities Lending Program. Given the increasingly diverse geographic nature of the broad utilization of these firms throughout the CalSTRS Securities Lending Program, ~~these lists are~~ this exposure is to be reviewed

regularly, with CalSTRS Investment Officers reserving the right to exclude or limit any borrower from the contractor's approved list program.

6. **CASH COLLATERAL PORTFOLIOS** – [Previously Policy #5] ~~The investment guidelines used in the management of collateral received in the form of cash (U.S. dollars) shall be based upon those followed within STRS' Fixed Income Policies and Procedures.~~ For that portion which is managed externally, the cash collateral portfolio holdings are reviewed regularly by STRS with the contractor. This review emphasizes the type, maturity, and quality of the investments purchased with the collateral proceeds. A similar review is performed for the internally managed portion of the cash collateral. Diversification within investment portfolios is critical in order to control risk and maximize returns. Minimum and maximum ranges, with respect to security types, credit exposure, and security maturity shall be established for the Cash Collateral Portfolios that are being managed both internally and externally. Such ranges shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.
7. **AUTHORIZAITON LIMITS** – Given that the total amount of trade activity for this program is governed by the investment and securities lending markets, no daily limits with respect to the approval of trade activity within the CalSTRS internally managed Cash Collateral Portfolio shall be established. However, prior to being processed to Operations, all trade tickets shall be authorized and countersigned by two Investment Officers within Fixed Income.
8. **AUTHORIZED SIGNERS** – Authorization letters, which indicate who may sign on behalf of CalSTRS shall be delivered to the appropriate parties. Whenever a change in authorized signers occurs, the affected parties shall be notified within 24 hours, in the event of termination, and as soon as possible in the event of a newly authorized signer(s).
9. **BUSINESS PLAN** – The Securities Lending Program will be managed in accordance with a Business Plan, which will be prepared on an annual basis and will describe CalSTRS' goals for the program and will include a plan for achieving such goals over the subsequent twelve month period.
10. **DELEGATION OF AUTHORITY** – The management of CalSTRS' Securities Lending Program is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.
11. **REPORTING** – Staff will prepare a monthly report for the Chief Investment Officer, which summarizes the activities associated with the management of the Securities Lending Program. The report shall provide information regarding program performance, risk characteristics, and operating statistics.
12. **BOARD REVIEW** – The Board shall administer and review this policy periodically, as it deems appropriate and in keeping with the investment standard.

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

GLOSSARY

AGENCY SECURITIES – Investments issued by federal corporations and federally sponsored corporations that are able to issue debt at a lower cost to such constituencies as farmers, homeowners, and students.

AGENT – An individual or organization who is authorized to act on behalf of another, called the principal.

BORROWER – An individual or organization who borrows securities in return for contracting into an obligation to repay those securities together with a fee payment.

COLLATERAL – An asset, such as U.S. dollars or other liquid securities, which is pledged to a lender in the event that a loan payment can not be met. The collateral may be appropriated from the borrower and sold in order to fulfill financial obligations.

COUNTERPARTY – An individual or organization on the opposite side of a loan.

CUSTODIAN – An agent, such as a broker or a bank, that stores a customer's investments for safekeeping.

LENDER – An individual or organization that lends securities to a borrower.

MARGIN LEVEL – The amount of cash or eligible securities the borrower will deposit when borrowing securities.

MARKED-TO-MARKET – An adjustment in the valuation of a security to reflect the current market values of the respective securities in the portfolio. This process is also used to ensure that margin accounts are in compliance with maintenance requirements.

PRINCIPAL – The major party in a transaction.

SECURITIES LENDING – An agreement between a lender and a borrower to transfer ownership of a security temporarily in order to earn additional income. The lender retains ownership rights of the security and is entitled to any distributions that occur with respect to that security during the life of the loan, such as coupon and dividend payments. The borrower backs the agreement by delivering collateral to the lender, either in the form of cash, which is currently the dominant form of collateral in securities lending transactions, or other liquid securities, in an amount that exceeds the market value of the securities borrowed.

UNITED STATES TREASURY SECURITIES – Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.

PROPOSED
RESOLUTION OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Securities Lending Program Policies

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Securities Lending Program Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Securities Lending Program Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Securities Lending Program Policies.

Adopted by:
Investment Committee
on _____

James D. Mosman
Chief Executive Officer